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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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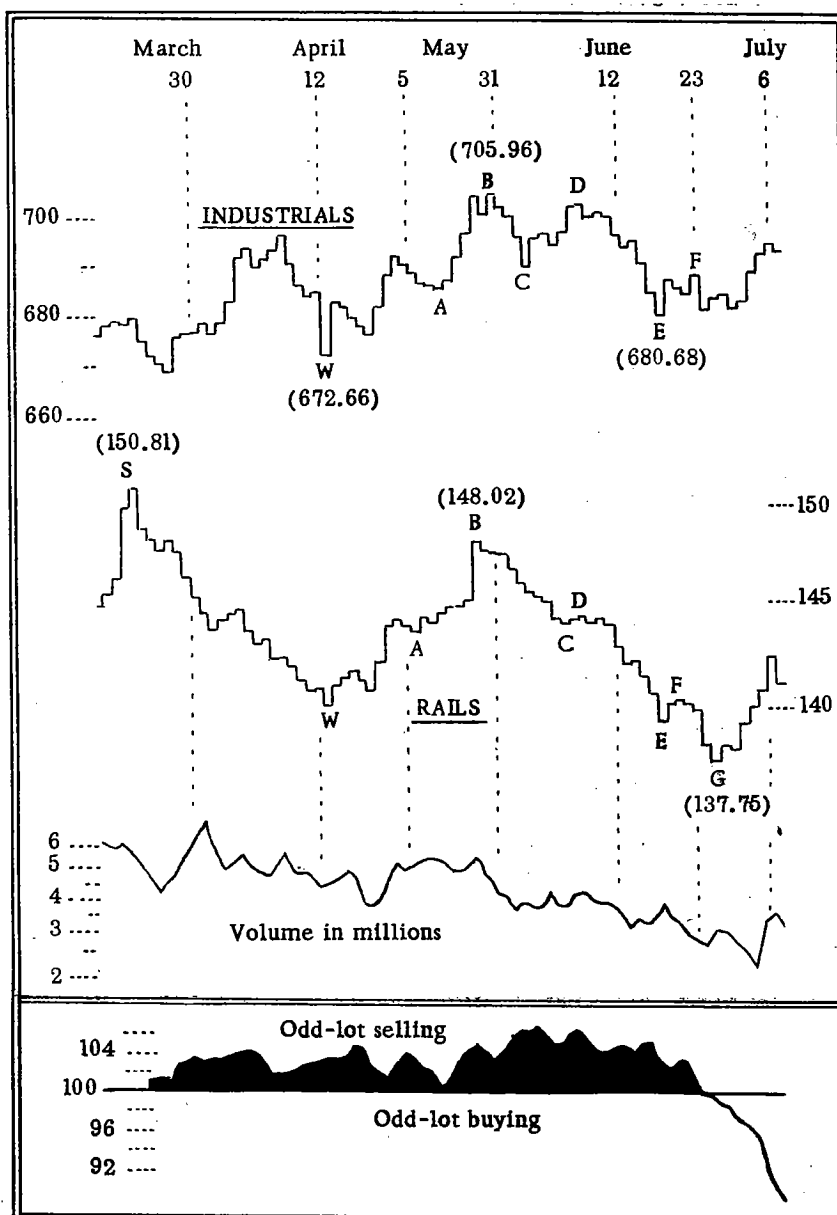
A quarter of a century ago Robert Rhea wrote that he had never known of a case where one man (over any reasonable length of time) had profited from the "tips" and "advice" of another. If this is true, subscribers may ask, why bother to write your Letters at all? The answer is that I have never advertised or sold these Letters on the basis of their being either a "tip sheet" or a system for "beating the market". The Letters are offered to serious investors and traders with the idea that such individuals may wish to learn something about Dow's classic Theory and the functioning of the market. A large number of subscribers to this service are investment advisers, professional traders, and economists (many are members of the New York Stock Exchange). These men use the Letters to check against their own opinions and conclusions, and I often learn as much or more from them as they learn from me. In the final analysis, all that we know and can deduce about stock movements is based on our knowledge of the past as applied to the present and the future.

THE MARKET The Rail decline from the March 22 peak of 150.81 lasted over three months and wiped out 48% of the entire Rail rise from the September, 1960 low. The Industrial decline from the May 19 peak of 705.96 lasted one month and erased 18% of the Industrial rise from the October, 1960 low. Although the duration and extent of the Rail decline falls within the requirements of a secondary retracement, the shallowness of the Industrial decline makes such a classification doubtful.

Both Averages recorded lows at the E points (see chart). Following a minor rally to F, the two Averages again retreated, and here Rails broke to a new low of 137.75 (G). Industrials refused to confirm the new Rail penetration, however, and for this reason I wrote in Letter 148: "The case for a strong or weak market now falls squarely on the Industrial Average." I further stated: "The ability of the Industrial Average to hold above points E (680.68) and W (672.66) will provide the first clues as to the near-term direction of the market."

On July 3 Industrials bettered point F, thus tracing an upward zig-zag. Rails advanced "in gear" and managed to better their own minor peak at F. Volume expanded on the rise but remained well below April and May levels.

The Industrial Average is now within striking distance of its former all-time high at B (705.96). For comparison purposes, it might be well to review the situation which prevailed at the previous B peak. At B the 5-day average of volume was 4.85 million shares (against a July 7 figure of under 3 million shares). On May 19 (B) the 5-day average of new highs was 108 (against a July 7 figure of 28).



The advance decline ratio (see Letter 147) recorded a high for the year on May 17, two days before the Industrial peak. The general market decline into mid-June followed. By July 7 the A-D ratio had regained only 30% of its May 17 to June 27 losses whereas the Industrial Average (on July 7) had regained 54% of its May 19 to June 19 losses. Thus, the A-D ratio (representative of the entire market) has lagged behind the Industrial Average and is not now in a position to confirm a possible new Industrial high. All in all, the comparison of the May 19 period with the most recent period remains unfavorable and caution is recommended.

CONCLUSION The primary trend is bullish; it will be reconfirmed as bullish if both Averages can better their preceding highs (Industrials - 705.96, Rails - 150.81). The secondary trend probably turned bearish when the A points were jointly violated. If the recent lows (Industrials at E - 680.68, Rails at G - 137.75) are violated by both Averages the picture will be ominously bearish.

ODD-LOTS The odd-lotter (under 100 share buyer) is generally considered to be representative of the public. Since February of this year odd-lot transactions have remained on the selling side (see Letter 145). With remarkable consistency, odd-lot ratios (daily odd-lot sales divided by purchases) have held around 105, which means that an average of 105 shares have been sold for every 100 shares purchased. The history of odd-lot transactions shows that the public is normally a buyer (a ratio of 90, or 10 shares bought for every 9 sold, might be considered "normal"); for this reason the recent protracted area of odd-lot selling was a stock market rarity (and a constructive one).

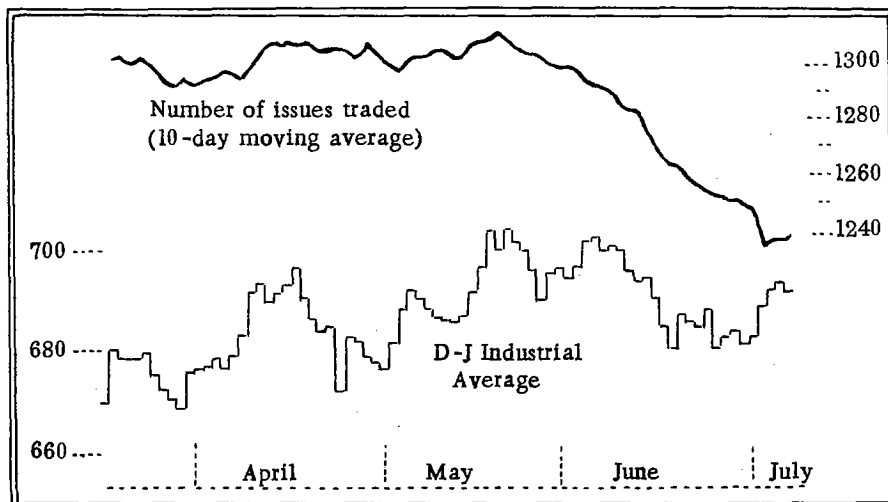
The chart on page 1 shows a 10-day moving average of odd-lot ratios from early March to the present. The solid black area clearly illustrates the long selling area. Note that odd-lots recorded their heaviest selling ratios in late May near the peak of the Industrial rise. Since then the ratios have moved towards less selling and finally to actual buying. On June 22 sufficient buying had occurred to put the 10-day moving average over on the buy side.

It should be understood that the normal tendency of the odd-lotter is to increase buying on market declines ("lower prices are bargains") and to decrease buying on rallies ("higher prices are selling opportunities"). Therefore, it was not too significant when odd-lotter switched to less selling and then to buying as prices declined following the May 19 Industrial peak. However, since June 27 stocks have rallied, and it is significant that odd-lotter have continued to increase their buying on the rally. Odd-lot transactions have now ceased to be a plus factor in the technical picture. Moreover, if odd-lot buying continues to increase with higher prices, that action must be considered definitely bearish.

ISSUES TRADED Over the last sixty years there have been a small handful of men who have been able to add something of value to our knowledge of the stock market. One of those men was Richard D. Wyckoff (founder of "The Magazine of Wall Street"). Back in the 1920's, Wyckoff made some careful studies of volume, "breadth" and the number of issues traded. Wyckoff noticed that the actual number of issues traded each day (like volume) bears a direct relationship to public participation in the market.

At important tops (and bottoms), observed Wyckoff, the number of issues (and volume) may expand to abnormal levels. This phenomenon suggests that elements who are not ordinarily in the market are being stirred out of their lethargy. As a rule, the only thing that can move these "retiring investors" into action is great enthusiasm (tops) and great fear (bottoms). At such times, wrote Wyckoff, "many a stock which has lain dormant for months is taken out of its pigeonhole, dusted off, and given a quotation."

"In a big bull market," explained Wyckoff, "everything is advancing, and everyone is trying to figure out what will go up next and fastest. Traders try to buy what will probably make the most money in the shortest time. This leads them to bid up above the last quotation for even the most inactive stock, on the ground that 'it ought to have a move'. Thus the movement spreads until two hundred or more stocks are dealt in (my note: two hundred was an abnormal number of issues to be traded in the mid-1920's), and we have what is known as a broad bull market, with everyone's holdings increasing in value.



"Great breadth of the market is a sign that the movement then under way will shortly culminate. Everything in the world climaxes at some time in history -- a planet, an earthquake, a storm, the power of government, the health of an individual, the life of a plant, a panic, a great bull or bear market, a ten-point swing or a little hourly fluctuation."

In view of Wyckoff's comments, it is worth noting that at the recent peaks established by the Industrial Average in April and May, the number of issues traded expanded to historic highs. The black line superimposed upon the Industrial Average on the accompanying chart shows a ten-day moving average of total issues traded from the period of March 17 to the present.

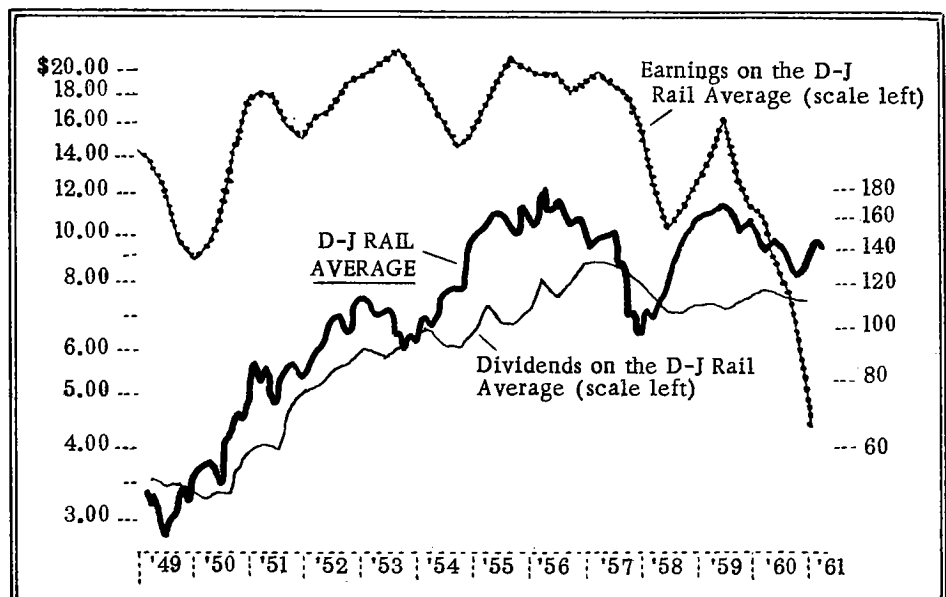
On April 11 the moving average rose to an all-time high of 1308. From that peak the market and the number of issues traded receded (as did volume). Then, on the Industrial Average rally to the 705.96 high, the number of issues traded expanded to another historic high of 1311 (May 18). As Wyckoff might have put it: "Everything that was not nailed down was offered for sale in mid-May."

The week of May 18 proved to be at least the temporary turning point for the market. That week the advance-decline ratio turned down, Barron's Low-Priced Stock Index turned down and the Industrial Average turned down. As seen on the chart, the decline from the mid-May high brought a steady contraction in the number of issues traded. If history is any guide, it will now take a violent upward surge or a severe decline to bring about (1) another round of heavy volume, and (2) a great expansion in the number of issues traded.

RAILS The accompanying chart shows twelve years of Rail action together with quarterly Rail earnings and dividends over the same period (earnings and dividends are plotted on an annual basis). The chart is particularly interesting because it directs attention to something which has not occurred since the mid-'40's -- the crossing over of the Rail dividend and earnings line.

The D-J Rail average produced a deficit of 4¢ in the third quarter of 1960 and a further deficit of 54¢ (just announced) in the first quarter of 1961. This means that for the year ending March 31, 1961, the Rail Average earned \$4.43 against a total dividend payout of \$7.88. In other words, Rail earnings are now falling far short of dividend requirements. (For

comparison: the Rail Average in the year ending March 31, 1960 earned \$10.81 against a total dividend payout of \$7.81). Moreover, based on a price of 141 and earnings through the first quarter of \$4.43, the Rail Average is now selling at 31.7 times earnings.



All this suggests that the Rails are at a critical juncture. As illustrated in the last Letter (see chart - Letter 148), rail carloadings have expanded no better than seasonally in 1961. In order to at least cover dividends, there will have to be a much better than seasonal upturn in carloadings over the period ahead. Because of the obvious pressure on rail earnings and dividends, the action of the Rail Average now assumes a particular significance. A steady advance in the carrier Average could mean that the nation's transportation (and sales) picture is about to take a turn for the better. Conversely, downward pressure on the Rails (and a new low on the Rail Average) will probably mean that the rail carloading (and profit) picture is continuing to deteriorate. The latter would exert a bearish influence on the entire market.

STOCKS Seven of the seventeen stocks in our "continuous study" group are now below their long-term (30-week moving average).

Anaconda broke above its 30-week moving average (M. A.) in January, then rose 18 points to its high of the year at 65. From the May peak, Anaconda declined to a low of 54 5/8, but held above its M. A. The 54-55 area is now the critical support level for Anaconda, since both the recent low and its current M. A. are at that level.

Letter 146 commented: "With little or no fanfare, Sears has been one of the strongest stocks in the Average." The strength continues in Sears, and last week the stock rose to a new all-time high of 71 3/4. Sears is getting too far from its M. A. (59 3/4) for comfort, however, and is overdue for a correction.

In June U. S. Steel broke below the 84 level, a level which had held on all declines from March to May. Steel is now well below its M. A. of 84 1/4 and shows little strength on market rallies.

International Harvester, the big farm equipment company, has been the strongest in its group. It has held above its M. A. (now 50 1/8) since January, 1961. Critical chart support is at 52, below which it should be sold.

Amer. Tel. was last reviewed in Letter 146. At that time I commented on the correction underway in T, and readers were cautioned to watch the M. A. level of 113. The decline in T stopped at exactly 114 1/2, following which, T climbed to its last week price above 120. The M. A. for T is now 116, and I continue to feel that the stock is vulnerable.

Back in Letter 135 I called attention to the huge ascending triangle in Avco and suggested purchases on a "breakout" above 17. The stock subsequently rose to 21, then formed a consolidation triangle. A month ago Avco broke upside again, and it has recently climbed above 23. This represents almost a 33% appreciation in four months. I would now place "stop-loss" orders fairly close to the market -- perhaps 1 1/2 points under the current price.

NOTE: Due to the two-week vacation close-down at my book-maker, delivery of "The Dow Theory Today" will be held up. Books should be mailed during the third week in July. Please pardon the delay.

(Written - July 10, Monday, 3 P. M.)

